

Message Text

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PAGE 01 MILAN 00464 01 OF 02 151647Z
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E.O. 11652: NXA
TAGS: EFIN, ECON, EINV, IT
SUBJECT: MILANESE BANKERS' VIEWS OF CURRENT ECONOMIC SITUATION

1. SUMMARY. DURING TALKS WITH AMERICAN AND ITALIAN BANKERS
IN MILAN MARCH 9-11 TREASOFFS IDENTIFIED FOLLOWING MAIN ECONOMIC
THEMS: (1) LIRA HAS WITHSTOOD DISMANTLING OF PRIOR DEPOSIT
AND ELIMINATION OF FOREIGN EXCHANGE TAX BETTER THAN HAD BEEN
EXPECTED, (2) LIRA RATE IS LIKELY TO REMAIN FAIRLY STABLE AT
LEAST UNTIL FOURTH QUARTER 1977 WHEN SOME DEPRECIATION MAY OCCUR,
(3) CURRENT AMOUNT OF SHORT-TERM FOREIGN LIABILITIES OF ITALIAN
BANKS IS LIKELY TO REMAIN STABLE OR EVEN RISE SOMEWHAT, (4) 1976
EXCHANGE CONTROL PENALTY LAW IS THOUGHT TO BE QUITE
EFFECTIVE IN SHARPLY REDUCING CURRENT AND FUTURE CAPITAL
FLIGHT, (5) DESPITE CURRENT QUANTITATIVE LIMITS ON
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PAGE 02 MILAN 00464 01 OF 02 151647Z

DOMESTIC BANK CREDIT, BANKS ARE FAIRLY LIQUID AND CREDIT
DEMAND IS NOT PARTICULARLY STRONG, (6) UNEXPECTED STRENGTH
OF 1976 ECONOMIC RECOVER IS NOW WIDELY RECOGNIZED BUT
INVESTMENT PROSPECTS ARE STILL NOT GOOD DUE TO CONTINUED
EXISTENCE OF UNUTILIZED PRODUCTIVE CAPACITY AND PERSISTENCE
OF ECONOMIC AND POITICAL UNCERTAINTIES, (7) INVENTORIES OF
IMPORTED RAW MATERIALS AND INTERMEDIATE GOODS ARE NOT

BELIEVED TO BE PARTICULARLY HIGH (8) EXPORT PRICES ARE GENERALLY STILL COMPETITIVE, BUT PROFIT MARGINS ARE BEING REDUCED FROM HIGH LEVELS PREVAILING IN MID-1976 FOLLOWING LARGE LIRA DEPRECIATION AND (9) SIGNIFICANT PROGRESS IS BEING MADE IN REDUCING TAX EVASION. END SUMMARY.

2. LIRA AND EXCHANGE MARKET

THERE WAS UNANIMOUS AGREEMENT THAT LIRA HAD WEATHERED ELIMINATION OF 7 PERCENT EXCHANGE TAX AND PROGRESSIVE DISMANTLING OF PRIOR DEPOSIT BETTER THAN HAD BEEN EXPECTED. BECAUSE OF SOME CURRENT AND EXPECTED CAPITAL INFLOWS (LIBYAN INVESTMENT IN FIAT, SOME CAPITAL REPATRIATION UNDER 1976 AMNESTY LAW, PROBABLY IMF AND EC CREDITS) AS WELL AS FAIRLY GOOD EXPORT PERFORMANCE, LIRA EXCHANGE RATE SHOULD BE RATHER STABLE IN COMING MONTHS UNTIL SEASONALLY FAVORABLE SUMMER PERIOD. THUS, ANY PERCEPTIBLE DEPRECIATION OF LIRA IS NOT LIKELY BEFORE LAST QUARTER OF 1977..ALWAYS ASSUMING THAT NO DRAMATIC POLITICAL EVENTS INTERVENE. BY END 1977 SEVERAL BANKERS FORESAW LIRA IN RANGE 910 TO 960 LIRE PER DOLLAR. THEY WERE ALSO IMPRESSED WITH WAY IN WHICH BANK OF ITALY HAS BEEN ABLE TO CONTROL EXCHANGE MARKET IN RECENT MONTHS. THIS WAS POSSIBLE BECAUSE OF A NUMBER OF FACTORS, PARTICULARLY SIZE OF PRESENT CONVERTIBLE CURRENCY RESERVES, WIDE INTEREST RATE DIFFERENTIAL IN FAVOR OF CAPITAL IMPORTS AND USE OF MORAL SUASION. BOI HAS CONSISTENTLY ASKED BOTH BANKS AND NON-BANKS PARTICIPANTS IN EXCHANGE MARKET TO CONCENTRATE MAJOR PURCHASES OF FOREIGN EXCHANGE AT FIXING AND TO LIMITED OFFICIAL USE

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PAGE 03 MILAN 00464 01 OF 02 151647Z

ACCEPT FIXING RATE FOR SUBSEQUENT TRANSACTIONS THAT DAY. LARGE OPERATIONS WHICH DO NOT FOLLOW THIS PATTERN HAVE OFTEN PROMPTED INQUIRIES FROM BANK OF ITALY. ANOTHER MAJOR FACTOR WHICH HAS LIMITED SPECULATION AGAINST LIRA HAS BEEN PROGRESSIVE REDUCTIONS IN INDIVIDUAL BANK CEILINGS ON SPOT POSITIONS TO COVER FORWARD TRANSACTIONS AND RE-DEFINITION OF "SPOT" TRANSACTIONS TO REDUCE SETTLEMENT DATES FROM AS MUCH AS 7 DAYS TO ONLY 3 DAYS. ALSO, REDUCED FORWARD TRANSACTIONS MUST BE LIMITED TO RESIDENT CLIENTS. RESULT HAS BEEN GREATLY REDUCE POSSIBILITY OF SPECULATION AGAINST LIRA BOTH BY FOREIGN BANKS AND BY DOMESTIC TRADERS. SEVERAL BANKERS THOUGHT THAT THIS REGULATION WOULD LIKELY BE LEFT IN PLACE FOR INDEFINITE FUTURE IN ORDER TO CONTINUE TO PROTECT LIRA.

3. FOREIGN BANK CAPITAL INFLOWS

BANKERS WERE AWARE OF CRITICAL ROLE THAT INFLOW OF SHORT-TERM BANK CAPITAL PLAYED IN 1976 IN HELPING BOI TO MANAGE BALANCE OF PAYMENTS IN FACE OF CURRENT ACCOUNT DEFICIT

OF MORE THAN \$3 BILLION. SOMEWHAT SURPRISINGLY, ALMOST ALL BANKERS THOUGHT THAT PRESENT LEVEL ABOUT \$3 BILLION IN SHORT-TERM FOREIGN LIABILITIES OF ITALIAN BANKS COULD CONTINUE THROUGH ROLLOVERS OF LOANS WHEN THEY MATURE. A NUMBER OF BANKERS EVEN FORESAW POSSIBILITY OF SLIGHT INCREASE IN OUTSTANDING DEBT. ONLY ONE BANKER SEEMED SERIOUSLY CONCERNED ABOUT LEVEL OF DEBT AND WONDERED IF IMF COULD NOT ESTABLISH CEILING ON SUCH DEBT. FACT THAT LARGE PART OF BORROWINGS ARE TIED TO REQUIREMENT FOR 50 PER CENT ADVANCE REPATRIATION OF EXPORTS SOLD ON CREDIT WAS STRESSED BY SOME BANKERS AS IMPORTANT FACTOR, SINCE SUCH CREDITS WERE "SELF-LIQUIDATING." (THIS "FACT" ALSO MEANS THAT EXCHANGE MARKET EFFECT OF THESE EXPORTS HAS ALREADY BEEN REALIZED AND THAT, IN A SENSE, IMPORT COVERAGE BY EXPORT RECEIPTS IN COMING MONTHS WILL BE CORRESPONDINGLY REDUCED.) FINALLY, A FEW BANKERS INDICATED THAT MEDIUM-TERM LOANS TO ITALIAN BORROWERS WERE BEING EXPLORED, LIMITED OFFICIAL USE

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PAGE 04 MILAN 00464 01 OF 02 151647Z

ALTHOUGH IT APPEARED THAT AMOUNTS INVOLVED SO FAR WERE FAIRLY MODEST, FOLLOWING LONG PERIOD OF NEAR EXCLUSION OF ITALIAN BORROWERS FROM TERM LOAN EUROMARKET.

4. CAPITAL FLIGHT

BANKERS WERE ALMOST UNANIMOUS IN BELIEVING THAT 1976 LAW CREATING CRIMINAL PENALTIES FOR EXCHANGE CONTROL VIOLATIONS HAS BECOME VERY IMPORTANT IMPEDIMENT TO CURRENT AND FUTURE ILLEGAL CAPITAL OUTFLOWS. TREASURERS POINTED OUT THAT SOME ECONOMIC FACTORS SUCH AS HIGHER INTEREST RATES IN ITALY THAN ABROAD, RELATIVE POLITICAL STABILITY AND STRENGTH OF LIRA WERE MITIGATING AGAINST CAPITAL FLIGHT AND THEY ASKED WHAT WOULD HAPPEN IN EVENT OF POLITICAL CRISIS. EVEN IN SUCH CASE MOST BANKERS THOUGHT THAT PENALTY LAW WOULD BE QUITE EFFECTIVE. ON OTHER HAND, FEW THOUGHT THAT THERE WOULD BE ADDITIONAL REPATRIATION OF ILLEGAL CAPITAL OUTFLOWS NOW THAT DEADLINE HAS PASSED AND ONE BANKER THOUGHT THAT MAIN EFFECT WOULD SIMPLY BE TO INCREASE COST OF "SERVICE" PROVIDED BY ILLEGAL CAPITAL EXPORTERS.

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PAGE 01 MILAN 00464 02 OF 02 151704Z

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LIMITED OFFICIAL USE SECTION 2 OF 2 MILAN 0464

5. CREDIT TIGHTNESS

BANKERS ADMITTED THAT THEY HAD BEEN SURPRISED THAT QUANTITATIVE CREDIT CEILINGS IMPOSED ON BANKS LAST FALL HAD NOT BEEN AS SEVERE AS EXPECTED. VARIOUS REASONS WERE GIVEN: (A) IN SOME CASES JUNE 1976 BASE PERIOD HAD BEEN QUITE HIGH; (B) ECONOMIC RECOVERY LED TO INCREASE IN PROFITS AND IN LIQUIDITY OF BUSINESSES; AND C) SHORT-TERM INFLOW OF FOREIGN CURRENCY CREDITS VIA BANKING SYSTEM AND FROM FOREIGN SUPPLIERS PROVIDED ALTERNATE SOURCES OF CREDIT. ONE BANKER SAID THAT LIRA LOANS TO FINANCE PRIOR DEPOSIT HAD INADVERTENTLY NOT BEEN COVERED BY CEILING AND BY TIME BOI DISCOVERED THIS IT DID NOT SEEM NECESSARY TO CLOSE THIS LOOPHOLE. WHILE BANK CREDIT DEMAND DID NOT SEEM PARTICULARLY STRONG NOW, BOTH BANKS AND THEIR CLIENTS WERE ATTEMPTING TO KEEP NEAR CEILINGS IN ORDER TO PRESERVE THIS BASE, IN EVENT THAT BANK OF ITALY DECIDED TO CONTINUE LIMITED OFFICIAL USE

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PAGE 02 MILAN 00464 02 OF 02 151704Z

CREDIT CEILING BEYOND END-MARCH TERMINATION DATE. IN FACT, MOST BANKERS TENDED TO BELIEVE THAT BOI WOULD KEEP MEASURE IN PLACE, PERHAPS IN SOMEWHAT RELAXED FORM. THIS WOULD PARTLY REFLECT BOI CONCERN THAT ECONOMIC SLOWDOWN MAY NOT OCCUR AS SOON AS ORIGINALLY CONTEMPLATED.

6. GROWTH AND INVESTMENT

AWARENESS OF STRENGTH OF ECONOMIC RECOVERY IN LAST QUARTER OF 1976 AND OF POSSIBILITY THAT STRONGER THAN EXPECTED ECONOMIC ACTIVITY MIGHT CONTINUE INTO 1977 WAS WIDESPREAD. HOWEVER, ONE BANKER THOUGHT THAT SLOWDOWN IN PRIVATE

CONSUMPTION HAD ALREADY BEGAN IN JANUARY AND THAT OVERALL SLOWDOWN IN ACTIVITY MIGHT BE SEEN BY MARCH-APRIL PERIOD. DESPITE ASSUMPTION THAT REAL GDP WOULD RISE BY ABOUT 2-3PER CENT THIS YEAR, THERE WAS VERY WIDE CONSENSUS THAT INVESTMENT GROWTH, IF ANY, WOULD BE VERY MODEST. WHILE THERE WERE DIFFERENCES FROM SECTOR TO SECTOR, UNUTILIZED CAPACITY WAS RATHER GENERALLY AVAILABLE, ESPECIALLY IN STATE-OWNED INDUSTRY WHICH BECAUSE OF ITS SIZE AND NEED FOR LONG-TERM PLANNING MIGHT OTHERWISE HAVE BEEN SOURCE OF ANTI-CYCLICAL INVESTMENT STRENGTH. IN SMALL AND MEDIUM PRIVATE INDUSTRY CAPACITY LIMITS MIGHT BE REACHED IN SOME CASES, BUT STILL WOULD NOT TRIGGER INVESTMENT DECISION BECAUSE OF DOUBTS ABOUT LONG-TERM PROFITABILITY OF FIXED INVESTMENT IN PLANT EXPANSION. FIRMS ARE PARTICULARLY ANXIOUS TO AVOID HIRING HIGH COST WORKERS ON BASIS OF WHAT MIGHT BE TRANSITORY STRENGTH IN ORDER BOOKS. SOME SMALL AND MEDIUM FIRMS, REPORTEDLY, HAVE TURNED DOWN ORDERS RATHER THAN PROCEED WITH NEW INVESTMENT. ON OTHER HAND, A CERTAIN AMOUNT OF INVESTMENT IN MODERNIZATION OF EQUIPMENT HAS BEEN PROCEEDING. WHEN ONE BANKER WAS ASKED WHAT HE THOUGHT BUSINESS WOULD DO WITH FUNDS RELEASED DUE TO EFFECT OF DECREE ON PARTIAL "FISCALIZATION" OF SOCIAL COSTS, HE REPLIED THAT RESOURCES WERE MOST APT TO BE USED TO REPAY HIGH-COST BANK DEBT RATHER THAN TO FINANCE NEW INVESTMENT.

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PAGE 03 MILAN 00464 02 OF 02 151704Z

7. INVENTORIES

THERE WAS CONSIDERABLE UNCERTAINTY ABOUT LEVEL OF IMPORTED INVENTORIES OF RAW MATERIALS AND DOMESTIC INVENTORIES OF FINISHED GOODS DUE TO LACK OF DEPENDABLE DATA ON THIS VARIABLE. HOWEVER, MOST BANKERS SEEMED TO THINK THAT THERE WAS NOT A PARTICULARLY HIGH LEVEL OF SUCH STOCKS AT PRESENT. PROBABLY THERE HAD BEEN SOME BUILD-UP EARLY IN 1976, RUNDOWN IN MID-1976 AND THEN STABILITY IN LATE 1976. ONE BANKER THOUGHT THAT HIGH COST OF FINANCING INVENTORIES WAS IMPEDING ANY LARGE SPECULATIVE BUILD-UP AND THAT SOME ITALIAN BUSINESSES WERE GRADUALLY COMING TO REALIZATION THAT SPECULATION IN INVENTORIES WAS NOT COST-FREE.

8. EXPORT PROSPECTS

THERE WAS GENERAL AGREEMENT THAT ITALIAN EXPORT PRICES ARE STILL COMPETITIVE IN WORLD MARKETS BUT THAT PROFIT MARGINS HAVE BEEN CONSIDERABLY ERODED SINCE MID-1976 FOLLOWING LARGE DEPRECIATION OF LIRA. THERE WAS RECOGNITION THAT LIRA MIGHT HAVE TO DEPRECIATE SLIGHTLY BY END-1977 IN VIEW OF CONTINUED EXCESS OF ITALIAN INFLATION RATE OVER THAT OF COMPETING COUNTRIES. NONETHELESS, ONE ITALIAN BANKER ARGUED STRONGLY THAT LIRA DEPRECIATION COULD ONLY PROVIDE TRANSITORY BENEFIT TO EXPORTERS BECAUSE OF LOW ELASTICITY

OF ITALIAN EXPORTS AND IMPORTS AND FEEDBACK EFFECT ON LABOR COSTS FROM LIRA DEPRECIATION. HE THOUGHT IT MORE IMPORTANT THAT RAPID RATE OF RISE IN UNIT LABOR COSTS BE ARRESTED BY INCREASING LABOR PRODUCTIVITY. MOST BANKERS WERE ENCOURAGED BY CHANGE IN LABOR/MANAGEMENT RELATIONS WHICH HAS DEVELOPED OVER RECENT MONTHS, INCLUDING IN THEIR OWN BANKS. ONE BANKER THOUGHT THAT EXPORT GROWTH WOULD BE SIGNIFICANTLY LIMITED BY RATHER SLOW RATE OF GROWTH OF ITALY'S MARKETS AND BY EXISTENCE OF PROTECTIONIST PRESSURES.

9. TAX EVASION

TREASOFFS HAD SEPARATE SESSION WITH TAX EXPRTS OF AMERICAN CHAMBER OF COMMERCE PARTLY DEVOTED TO QUESTION OF STATUS OF LIMITED OFFICIAL USE

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PAGE 04 MILAN 00464 02 OF 02 151704Z

GOI EFFORTS TO REDUCE TAX EVASION. THERE WAS WIDE AGREEMENT THAT MORE COMPLETE WITHHOLDING AT SOURCE ON WAGE AND SALARY INCOME PLUS WITHHOLDING ON INTEREST AND DIVIDENTDS UNDER 1974 INCOME TAX REFORM HAS SIGNIFICANTLY REDUCED AREA OF POSSIBLE TAX EVASION. FURTHERMORE, PROSPECT OF COMPUTERIZATION OF TAX RETURNS AND MORE DETERMINED EFFORT BY TAX COLLECTION OFFICIALS HAVE FRIGHTENED MANY SMALL COMPANIES AND SELF-EMPLOYED INDIVIDUALS SO THAT THEY, TOO, ARE BEINNING TO SUMIT MOE ACCURATE AND HONEST TAX REURNS. SOME PROGRESS HAS ALSO BEING MADE IN COLLECTION OF VALUE ADDED TAX, WITH BUSINESSES GRADUALLY SUBMITTING DATA ON VOLUME OF SALES SO AS TO APPROACH ACTUAL LEVELS. INTENT IS TO AVOID TOO ABRUPT APPEARANCE OF GROWTH IN SALES AND TRIGGER INVESTIGATION BY TAX AUTHORITIES. FEAR OF COMPUTERIZATION IS ALSO IMPORTANT HERE, AS WELL AS SOME UPGRADING IN QUALITY AND TRAINING OF TAX COLLECTION PERSONNEL IN INDIRECT TAXATION FIELD.

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